

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
SCHOLASTIC SPECIALTY CORP.	:	DETERMINATION
AND DAVID FUND, AS OFFICER	:	DTA NO. 807459
	:	
for Revision of Determinations or for Refund	:	
of Sales and Use Taxes under Articles 28 and 29	:	
of the Tax Law for the Period June 1, 1983	:	
through May 31, 1986.	:	

Petitioners, Scholastic Specialty Corp. and David Fund, as officer, c/o S. Buxbaum & Co., P.C., 55 Virginia Avenue, West Nyack, New York 10994, filed a petition for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period June 1, 1983 through May 31, 1986.

A hearing was held before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on January 7, 1991 at 2:45 P.M., with all briefs to be submitted by May 3, 1991. Petitioners filed a brief on March 11, 1991. The Division of Taxation did not file a brief. Petitioners appeared by James H. Tully, Jr., Esq., and Stewart Buxbaum, C.P.A. The Division of Taxation appeared by William F. Collins, Esq. (Robert J. Jarvis, Esq., of counsel).

ISSUES

- I. Whether the Division of Taxation acted properly in estimating the tax due from petitioners rather than making an exact calculation of their tax liability.
- II. Whether penalties and interest above the minimum should be cancelled.

FINDINGS OF FACT

On February 19, 1987, the Division of Taxation ("Division") issued to petitioner Scholastic Specialty Corp. ("Scholastic") two notices of determination and demands for payment of sales and use taxes due. The first notice assessed a tax of \$170,248.21 for the

period June 1, 1983 through May 31, 1986 plus penalty and interest. The second notice assessed an additional penalty for the period June 1, 1985 through May 31, 1986 of \$5,318.39. On the same date, the Division issued notices of determination to petitioner David Fund, as an officer of Scholastic, assessing identical amounts of tax, penalties and interest, for the same periods of time.

Scholastic is in the business of producing and selling school uniforms and miscellaneous items of clothing associated with those uniforms. Its merchandise is predominantly aimed at children attending parochial schools in and around New York City. Mr. Fund's father-in-law operated Scholastic for many years before Mr. Fund became involved in the business. In its early years, Scholastic sold uniforms through school administrations. A school's teachers or principal would collect money for school uniforms from the students and place the orders with Scholastic. If a student could not afford the price of a uniform, either the school administration or Scholastic would donate the price in whole or in part. When the business was being run in this fashion, Scholastic requested advice from the New York City Department of Finance regarding its sales tax liabilities. It was told that the sales were being made to the schools, not the students, and, therefore, Scholastic need not collect any sales tax.

Over the years, Scholastic's method of doing business changed. During the audit period, uniforms were sold and delivered directly to the students (or their parents). A Scholastic employee went to the schools to measure the students for uniforms and prepared a "shipping memorandum" showing the student's name and address, the student's school, items ordered, the price of each item, the total sales amount, shipping charges and the total amount due. Parents paid the amounts shown on the shipping memorandums directly to Scholastic, and the items of clothing were shipped directly to the students' homes. The memorandums were retained as records of shipping because such records were required by the Interstate Commerce Commission. Scholastic also sold its products to retailers for resale and maintained separate invoices for these sales.

Scholastic is a registered vendor, and during the audit period it filed sales tax returns

consistently reporting no taxable sales. It was Scholastic's position during the audit that its sales were actually made to the schools and to retailers for resale, and, therefore, that it was not required to collect sales tax on any of its sales. This position was abandoned at hearing, but it somewhat explains the course of the audit and the methodology adopted by the Division.

The audit of Scholastic began in May 1986. The Division sent Scholastic a letter dated May 1, 1986, scheduling a field examination of Scholastic's books and records for the period June 1, 1983 through February 28, 1986. Scholastic was instructed to make available all books and records pertaining to its sales tax liability for the period under audit. Attached to the letter was a checklist of particular records required including: a general ledger; a cash receipts journal; a cash disbursements journal; Federal income tax returns for the years 1984 and 1985; sales tax returns; cancelled checks; purchase invoices, sales invoices and expense invoices for a period "to be determined later"; fixed asset invoices; and resale, exempt and capital improvement certificates supporting nontaxable sales.

The examination of books and records was conducted at the office of Scholastic's accountant, Kenneth Cohen. Scholastic provided the Division with the following records: Federal and State income tax returns with related workpapers, sales invoices, purchase invoices, a general ledger, a check register and cancelled checks, monthly bank statements, journal entry sheets, and resale and exempt organization certificates. The auditor's workpapers state that the only record requested which was not made available was a regular sales journal. The Field Audit Report states: "Vendor maintains adequate books and records, however, since the resulting assessments were not generated through the use of the tests of the records, the test period agreement was not obtained".

The sales invoices made available by petitioner consisted, in part, of invoices prepared by Scholastic for the schools. Scholastic paid a commission to each school based upon total student sales at the school. Each November, Scholastic prepared invoices summarizing sales to students by school for the purpose of computing the school's commission. On audit, Mr. Cohen explained that these were the invoices relied on by Scholastic to prepare its Federal and State

income tax returns. Apparently, he also offered these invoices to the auditor as evidence that the uniform sales were made to the schools and not the students. Scholastic also provided the Division with invoices documenting its sales to retailers and with resale certificates substantiating the nontaxable status of those sales.

On audit, the Division maintained that Scholastic's retail sales were made directly to the students and not to the schools. It based this position on several factors, including, primarily, Scholastic's records, which showed that the uniforms were paid for by the students' parents and that the monies were collected by and paid directly to Scholastic. Accordingly, the Division's calculation of Scholastic's sales tax liability focused upon a computation of the sales made to students.

In the course of the audit, Mr. Cohen described to the auditor the shipping memorandums which documented the sales to students. There is some dispute between the parties regarding the Division's course of action with respect to these documents. The following handwritten notation appears in the audit workpapers:

"Discussion with acct. Told him [the Division's]...position -- sales to the schools are really sales to the individual students -- Based on fact that the payment is made directly from the student to Scholastic Spec.

Acct. stated that the invoice that Spec. sends to the student is not an invoice, but a memo of acct. We say that it is the invoice. It is this document that student acts on & pays, again directly to Spec."

The notation continues, but it does not indicate that the student invoices or memorandums were requested for review. The auditor, Jose Rances, under cross-examination testified as follows:

"Q: But yet you have testified that there was a record kept at the accountants called the 'shipping memo record' and which would describe where these uniforms were shipped?

A: We asked the accountant about these memorandums and he said they were not available at the time and that this invoice that he showed us [the invoices to the schools] were the invoices.

* * *

Q: That you asked the accountant for the memo shipment file, whatever it's called, and he refused to give it to you?

A: I didn't say he refused.

* * *

I said during the discussion of this 'memo forms' I was asking if they were available, and he said, 'No they were not available.' That the invoices that he presented to us are the invoices."

Mr. Cohen testified that Scholastic maintained the shipping memorandums and that they were available for examination, but that the Division never asked to review them. He estimated that the shipping memorandums filled 20 "books" (apparently, meaning cartons). Although Scholastic contended that the shipping memorandums could be traced through its books and records to calculate its taxable sales exactly, it presented no evidence to show the manner in which the shipping memorandums were maintained, the order in which they were kept, or the method that could be used to trace the memorandums to other books of account.

For its own internal accounting purposes and to calculate gross receipts for income tax purposes, Scholastic maintained a set of books and records essentially premised upon bank deposits. Scholastic entered into evidence examples of the following records:

(a) A Deposit Journal. This consisted of looseleaf pages where Scholastic listed its bank deposits. Deposits were made regularly, if not on a daily basis. Checks received from students were totaled and entered on the looseleaf sheets by school. Other receipts (sales to retailers, loans received, etc.) were listed by source and amount. The total receipts from all sources were intended to equal the bank deposits for that day.

(b) Accountant's ledger sheets. Mr. Cohen posted the daily bank deposit figures to ledger sheets. Ledger sheets entered in evidence were transcribed by the auditor from the accountant's records and were referred to as a summary of bank deposits. Entries on the ledger sheets correlate with daily figures shown on the sample page of the deposit journal.

(c) Journal of customer accounts. Scholastic maintained a hardcover journal where it listed its regular customers in alphabetical order and posted orders and payments received from those customers by month. The schools, not the students, are listed in this journal. Monthly figures taken from this journal were the basis for the annual invoices prepared for the schools.

(d) Shipping memorandums or sales invoices. These were described in detail in Finding of Fact "3".

In addition to the listed records, Scholastic also maintained a general ledger. The auditor testified that "[t]he bank deposit and general ledger are one of the same". This comports with Mr. Cohen's description of the general ledger as a summary, prepared on a "catch as catch can" basis, for income tax purposes. Year-end adjustments were made in the general ledger to reflect checks returned for insufficient funds. For this reason, the general ledger showed lower annual receipts than did the invoices prepared for the schools and retail establishments.

To determine Scholastic's taxable sales for the audit period, the Division followed the following procedure:

(a) The auditor transcribed all invoices for the audit period. These were divided into two groups, invoices representing sales for resale and the annual invoices made out to individual schools. The invoice amounts were segregated by sales tax jurisdiction (New York City, Nassau County, Suffolk County, Yonkers and Westchester) based upon the location of the retail business or school to which the invoice was written.

(b) The invoice amounts were totaled as a whole and by jurisdiction to compute total audited gross sales and audited gross sales by sales tax jurisdiction. Sales for resale were subtracted from gross sales to calculate taxable sales by jurisdiction. Taxable sales in each jurisdiction were then divided by total audited gross sales for all jurisdictions. The resulting percentages represented a taxable percentage by jurisdiction. For example, as calculated by the Division, New York City had taxable sales of \$1,904,851.90. This figure was divided by audited gross sales for all jurisdictions of \$3,219,006.98 to calculate a taxable percentage of 59.17%.

(c) The jurisdictional percentages were applied to Scholastic's bank deposits. Because the general ledger (or record of bank deposits) was maintained on a calendar year basis, the Division adjusted the bank deposits to allocate them to sales tax quarterly periods. The adjustment consisted of adding deposits for a six-month period and dividing the result by two to

calculate bank deposits per sales tax quarters. Referring back to the example above, the Division determined that Scholastic's taxable New York City sales amounted to 59.17% of its total audited gross sales. Bank deposits for the first six months of the audit period were determined to be \$549,945.65. This figure was divided by two to calculate bank deposits for the period June 1, 1983 through August 31, 1983 of \$274,972.82. The taxable percentage for New York City (59.17%) was applied to bank deposits to calculate taxable sales for the period ended August 31, 1983 of \$162,701.41. The same procedure was used for each quarter and each taxing jurisdiction. The appropriate tax rate was applied to taxable sales for each jurisdiction to calculate tax due.

At the end of the audit, the period of assessment was extended to include two quarterly periods not originally included in the audit period. The auditor's workpapers show that bank deposits were estimated for those quarters. Following a conciliation conference, the Division issued conciliation orders, dated August 25, 1989, reducing the tax assessed against Scholastic and Mr. Fund to \$141,638.47. This represents a cancellation of the tax assessed for the last two tax quarters of the assessment period. The conciliation orders also cancelled penalty and reduced interest to the minimum. No conciliation orders were introduced into evidence with regard to the notices of determination which assessed a separate penalty.

After the notices of determination were issued, the Division surveyed 51 schools asking them whether they or their students paid for uniforms purchased from Scholastic. All 39 of the schools which responded stated that the students paid Scholastic directly for the uniforms.

The Division's auditor explained that bank deposits were used as the base from which to calculate taxable sales because they took into account year-end adjustments for returned checks while the invoices did not. As a consequence, the total of all bank deposits (\$3,069,182.59) was less than the sum of the sales invoices (\$3,219,006.98). Under cross-examination, the auditor admitted that the Division had a record of monthly bank deposits and could have used that record to calculate quarterly bank deposits more exactly, rather than using an estimate based on a six-month period.

SUMMARY OF PETITIONERS' POSITION

Petitioners maintain that the Division's method of estimating tax due is arbitrary and capricious since adequate books and records were available from which the Division could have calculated the exact tax due. They argue that, inasmuch as the Division takes the position that sales were made to the students and not to the schools, the location of each sale was that of the individual student's home and not that of the school. Petitioners assert that the shipping memorandums are original source documents from which the Division could have determined the exact location and date of each sale and hence the exact amount of tax due per quarter by sales tax jurisdiction. In addition, they contend that there was no rationale for allocating sales to quarterly periods by averaging bank deposits since records were available from which the Division could have determined exact monthly deposits.

In the alternative, petitioners claim that the amount of tax assessed by the Division is incorrect. Using transcripts of bank deposits made by the Division's auditor, petitioners' accountant calculated the exact amount of bank deposits per month and then per sales tax quarter. The accountant then calculated petitioners' total sales tax liability for the period June 1, 1983 through November 30, 1985 using the same methodology as that employed by the Division. Total sales tax due calculated in this fashion amounted to \$139,365.59, compared to the Division's determination of \$141,638.47. Petitioners contend, however, that their total tax liability is no more than \$77,547.13. This amount was computed by selecting the lower of the Division's computations and petitioners' computations per quarter. For example, the Division estimated tax due of \$15,200.78 per quarter for the period June 1, 1983 through November 30, 1983. By using actual bank deposits, petitioners calculated tax due of \$17,895.17 for the quarter ended August 31, 1983 and \$3,081.47 for the quarter ended November 30, 1983. By accepting the Division's calculations when they resulted in a lower tax amount, petitioners determined their own liability for the two quarters to be \$18,282.25 (\$15,200.78 plus \$3,081.47). In some quarters, the difference between the Division's figures and the petitioners' is significant. For instance, for the quarter ended August 31, 1985, petitioners calculated tax

due of \$33,989.20 while the Division calculated tax due of \$12,287.10. For the period ended February 28, 1985, the Division calculated tax due of \$14,681.27 while petitioners calculated a tax liability of \$619.64. Thus, by consistently selecting the lower of the Division's and their own calculations, petitioners reduced their tax liability from \$139,365.59 to \$77,547.13.

Mr. Fund testified that between five and ten percent of the students purchasing uniforms lived outside New York State. On this basis, petitioners argue that their tax liability should be further reduced by \$7,754.71 (10% of \$77,547.13) to reflect out-of-state sales.

CONCLUSIONS OF LAW

A. Pursuant to section 1135(a)(1) of the Tax Law, every person required to collect sales and use taxes is also required to "keep records of every sale...and of all amounts paid, charged or due thereon and of the tax payable thereon...." Such records must include a true copy of each sales slip, invoice, statement or other memorandum of sale, separately stating the amount of tax due (Tax Law § 1135[a][1]; see also, 20 NYCRR 533.2[b]).

If a return required by article 28 is not filed, or if a return when filed is incorrect or insufficient, the Commissioner of Taxation and Finance is authorized to determine the amount of tax due "from such information as may be available", and to estimate the tax on the basis of external indices if necessary (Tax Law § 1138[a][1]). "When the vendor maintains a comprehensive set of books and records, 'such information as may be available' (Tax Law § 1138[a][1]) is restricted to his books and records, and not external indicia, because 'the honest and conscientious taxpayer who maintains comprehensive records as required has a right to expect that they will be used in any audit to determine his ultimate tax liability'" (Matter of Cafe Europa, Tax Appeals Tribunal, July 13, 1989, quoting Matter of Chartair v. State Tax Commn., 65 AD2d 44, 411 NYS2d 41, 43).

To determine the adequacy of a taxpayer's records, the Division must first request and thoroughly examine the taxpayer's books and records for the complete audit period (Matter of Adamides v. Chu, 134 AD2d 776, 521 NYS2d 826, 828; see also, Matter of Max Service Center, Tax Appeals Tribunal, September 29, 1988). The purpose of the examination is to

determine, through verification drawn independently from these records, whether they are adequate for the purpose of verifying the taxpayer's sales tax liability (Matter of Chartair v. State Tax Commn., supra). The Commissioner cannot simply ignore a taxpayer's records and use an indirect method of estimating tax due if the taxpayer's records are readily available and provide an adequate basis on which to determine the amount of tax due (Matter of Christ Cella v. State Tax Commn., 102 AD2d 352, 477 NYS2d 858, 859; Matter of Chartair v. State Tax Commn., supra). If the taxpayer's books and records do not provide an adequate basis for determining the tax liability, the Division must select an audit method which results in a reasonable calculation of the taxpayer's sales tax liability (Matter of W. T. Grant Company v. Joseph, 2 NY2d 207, 159 NYS2d 150,157, cert denied 355 US 869). When the Division follows this procedure, the burden of proof is on the taxpayer to show that the method of audit or the amount of tax assessed was erroneous (Matter of Surface Line Operators Fraternal Org. v. Tully, 85 AD2d 858, 859, 446 NYS2d 451, 453); however, if it is shown that the Division's audit methodology is fundamentally flawed, the taxpayer need not prove that the result produced by that methodology is different from that which a detailed examination would have produced (Matter of Babylon Milk & Cream Co. v. Bragalini, 5 AD2d 712, 169 NYS2d 124, affd 5 NY2d 736; see also, Matter of Adamides v. Chu, supra; Matter of King Crab Rest. v. State Tax Commn., 134 AD2d 51, 522 NYS2d 978).

B. The first issue to be addressed is whether the Division's failure to examine the shipping memorandums renders the entire audit invalid. There is no question that the Division was aware of the existence of the shipping memorandums and was aware that they contained information which might be used to calculate the exact amount of tax due during the audit period. Its position on audit was that the shipping memorandums constituted proof of sales to the students and not the schools. In fact, it insisted, over petitioners' objections, that the shipping memorandums were sales invoices. Generally, the audit appointment letter would be considered an adequate request for all records, including the shipping memorandums. But, in this case, a checklist attached to the letter indicated that the period for which sales invoices were

requested was "to be determined later". Thus, the letter left open the question of exactly which records were to be provided on audit. The parties disagree as to whether the Division made any request to review the shipping memorandums. Evidence offered by the Division on this point was equivocal and indicates that the auditors never made a positive, direct request to examine the shipping memorandums. If any request was made, it was weak and casual at best. It is apparent that the Division, although aware of the existence of the shipping memorandums, decided to employ an audit method which did not utilize them in any fashion.

The shipping memorandums contained sufficient information to satisfy the criteria of section 1135 of the Tax Law, with one exception, i.e., they do not state the amount of sales tax payable on each sale. However, the exact amount of tax due on each transaction could have been calculated using the shipping invoices, and there is no evidence in the record to refute petitioners' accountant's testimony that Scholastic maintained a complete set of shipping memorandums. Moreover, the Division has not claimed that the shipping memorandums were not adequate records of sales and has never put forth a rationale for not examining the shipping memorandums or making use of them in its audit.

C. While the Division's calculations of tax due relied on petitioners' books and records, estimating techniques were employed, at least for the purpose of allocating sales to quarterly periods and taxing jurisdictions. The Division may not use such estimating procedures if the exact amount of tax due can be calculated from the taxpayer's books and records (Matter of Chartair, Inc. v. State Tax Commn., *supra*), and the Division cannot know whether the amount of tax due can be calculated from the taxpayer's books and records unless it first requests and examines those records (Matter of King Crab Rest. v. State Tax Commn., *supra*; Matter of Max Service Center, Tax Appeals Tribunal, September 29, 1988). Having determined that the shipping memorandums were sales invoices, the very documents required to be kept by Tax Law § 1135, it was incumbent upon the Division to make a clear and positive request for the shipping memorandums and to review them before resorting to an indirect method of calculating petitioners' sales tax liability. Since the record indicates that such a request was not

made, the notices of determination must be canceled.

D. In light of Conclusion of Law "C", other issues raised by petitioners need not be addressed.

E. The petition of Scholastic Specialty Corp. and David Fund, as officer, is granted and the notices of determination and demands for payment of sales and use taxes due issued on February 19, 1987 are cancelled.

DATED: Troy, New York

9/5/91

ADMINISTRATIVE LAW JUDGE